

Service Date: November 30, 1981

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

* * * * *

In the Matter of the Application by)	UTILITY DIVISION
Great Falls Gas Company for authority)	
to establish increased rates for natural)	DOCKET NO. 81.4.44
gas in the State of Montana.)	ORDER NO. 4804b

APPEARANCES

FOR THE APPLICANT:

Richard F. Gallagher, Attorney at Law, Church, Harris, Johnson & Williams, P.O. Box 1645, Great Falls, Montana, appearing on behalf of the Applicant.

FOR THE INTERVENORS:

James C. Paine, Montana Consumer Counsel, 34 West Sixth Avenue, Helena, Montana 59624, appearing on behalf of the consuming public of the State of Montana.

FOR THE COMMISSION:

Calvin K. Simshaw, Staff Attorney

BEFORE:

GORDON E. BOLLINGER, Chairman
JOHN B. DRISCOLL, Commissioner
HOWARD L. ELLIS, Commissioner
CLYDE JARVIS, Commissioner
THOMAS J. SCHNEIDER, Commissioner

FINDINGS OF FACT

PART A

General

1. Great Falls Gas Company (GFG or Applicant) is a public utility furnishing natural gas service to consumers in the State of Montana.

2. On April 24, 1981, Great Falls Gas Company filed an application with this Commission requesting additional annual revenues in the amount of \$1,431,607.

3. On May 15, 1981, a prehearing conference was held, and rules for the disposition of this case were developed.

4. On May 26, 1981, a Procedural Order was issued.

5. On June 5, 1981, the Commission issued Interim Order No. 4804 which granted additional annual revenues in the amount of \$369,769.

6. On September 10, 1981 notice of public hearing was given.

7. On October 6, 1981 at 10:00 a.m. pursuant to the notice, a hearing was held in Room 200, Civic Center, Park Drive and Central Avenue, Great Falls, Montana. The hearing was concluded on October 7, 1981.

8. At the beginning of the hearing counsel for Great Falls Gas advised the Commission that: the Applicant and the Montana Consumer Counsel (MCC) had agreed that actual 12 months ended May 31, 1981 sales volumes would be used in this Docket. In addition, the entire test year would be updated to May 3, 1981. A significant number of issues were resolved by both parties prior to hearing.

9. The Commission commends the spirit of cooperation which prevailed in proceeding. In agreeing with the use of an updated test year the Commission notes that this is not consistent with past practice. The reason for establishing test years and the associated data is to allow all parties to examine the evidence in a particular case. There is a clear danger in presenting revised data in that parties may not have adequate time to examine the new filing. For the purposes of this specific case, the 12 months ended May 31, 1981 test year is found by the Commission to be a reasonable period within which to measure Applicant's utility revenues, expenses and returns for the purpose of determining a fair and reasonable level of rates for natural gas service.

10. The office of the Montana Consumer Counsel has participated in the proceedings of this Docket since their inception.

PART B

Capital Structure and Associated Costs

CAPITAL STRUCTURE

11. Applicant proposed the following capital structure and associated costs:

<u>TYPE</u>	<u>CAPITAL STRUCTURE</u>	<u>COST</u>	<u>WEIGHTED COST</u>
Long-Term Debt	51.53%	8.90%	4.59%
Common Equity	48.47	16.00	7.76
	<u>100.00%</u>		<u>12.35%</u>

12. MCC proposed the following capital structure and associated costs:

<u>TYPE</u>	<u>CAPITAL STRUCTURE</u>	<u>COST</u>	<u>WEIGHTED COST</u>
Long-Term Debt	60%	8.90%	5.30%
Common Equity	40	14.50	5.80
	<u>100%</u>		<u>11.10%</u>

13. The capital structure proposed by MCC witness, Dr. Caroline Smith was a utility industry average. Dr. C.M. Smith testified that the common equity ratio of Great Falls Gas Company is 20 percent higher than the industry average (Direct, p. 48). Dr. C.M. Smith does not recommend the actual capital structure be used by the Commission as it is not the “most efficient” capital structure. The hypothetical capital structure proposed by MCC is designed to provide a fair rate of return to the Applicant and avoid an overstated revenue requirement. Dr. C.M. Smith presented a version of the actual capital structure she developed for comparison. In her actual capital structure Dr. Smith removed a contingent liability in the amount of \$478,030. This contingent liability relates to properties owned by a subsidiary (Vesta).

Applicant's capital structure is based upon a 48.47 percent common equity ratio. This percentage is based upon 1930-year-end equity, less investment in nonutility subsidiaries (Vesta and Mountain Sun). Debt was based upon 1981 year-end long-term debt and 1980 average short-term debt.

14. In response to Dr. C.M. Smith's proposed treatment of the contingent liability which is described in the annual report to the stockholders, Great Falls Gas Company made two points; (1) the appraised value of the properties is far in excess of \$478,030 and (2) there is no actual information which indicates that the Applicant's ability to obtain long-term financing has been reduced by the contingent liability. Based on the evidence in this record the Commission rejects the adjustment for the contingent liability because the value of the properties is substantially greater than the liability.

15. A capital structure which is composed of nearly 50 percent equity is unusual and is of serious concern to this Commission. It is not typical for a utility capital structure to contain equal parts of equity and debt. MCC argues that the actual capital structure of Great Falls Gas is not the most efficient capital structure. While the Commission agrees with MCC that the actual level of equity in the capital structure is too high, the use of a 40/60 equity to debt ratio is rejected. Use of such a ratio would be excessive unless strong evidence supporting its use was presented.

Rather than use an industry average capital structure, the Commission finds that the capital structure presented in Docket No. 6701 to be appropriate in this Docket. In making this adjustment, the Commission accepts the concept of an efficient capital structure.

16. The appropriate capital structure is:

<u>TYPE</u>	<u>RATIO</u>
Long-Term Debt	54.8%
Common Stock	<u>45.2</u>
	100.0%

Cost of Debt

17. The cost of debt capital is not a contested issue in this case. The cost of long-term debt has been determined to be 8.90 percent by the Applicant and MCC. This cost is acceptable to the Commission.

Cost of Common Equity

18. Dr. Richard K. Smith, an independent financial consultant presented testimony and exhibits showing the cost of equity he derived from his analysis performed for the Applicant. His testimony contained comments on recent trends in inflation and interest rates. Dr. R.K. Smith noted that the cost of borrowed capital has increased sharply over the past two years. He notes the effect of rising interest rates on the cost of equity capital:

We can be sure that the cost of common equity has increased by a substantial amount also. When interest rates rise, investors will buy common stocks only if they can expect higher returns than before. (Direct, p. 4)

Cost of Common Equity

19. Dr. R. K. Smith performed a discounted cash flow (DCF) study. The DCF analysis was based on data derived from two sets of comparisons which are comparable to the Applicant. The 14 primary comparison companies are the same ones used by Dr. Richard K. Smith in Docket No. 6701. The seven secondary comparison companies include five companies used by Dr. Richard K. Smith presented in 1979 and two companies which were added as price quotations became available.

20. The results of his study indicate that the cost of common equity falls in the range of 16 to 17 percent. Great Falls Gas requested a return on equity of 16 percent.

21. Dr. Richard K. Smith used five criteria to select his comparison companies:

1. The primary activity of the company is the retail distribution of natural gas.
2. The total operating revenues of the company in its latest fiscal year ending before December 31, 1980 were at least \$5 million and not more than \$100 million.
3. The company paid dividends in every year for the period of eleven years ending with the latest year.

4. The company's financial statements are published in Moody's Public Utility Manual.
5. Price quotations are available on the company's common stock from the Wall Street Journal or D. A. Davidson.
22. Dr. Richard Kay Smith in Exhibit 7 indicates that the median yield is 9.28 percent for the 14 primary companies and 9.39 percent for all 21 companies.
23. Dr. Richard Smith gave four areas particular attention in estimating dividend growth:
 1. He placed more emphasis on dividend growth rates over the past 3 to 5 years than on growth rates over the past 10 years.
 2. Median historical growth rates rather than arithmetic averages were used.
 3. Growth rates of earnings per share and book value per share were considered along with the growth of dividends per share.
 4. The return on equity and the earnings retention ratios of the companies were taken into account.

Exhibit 8 reflected growth rates of 7.07 percent and 6.65 percent derived from the return on equity and profit retention ratio. It is Dr. Richard Smith's judgment that the expected dividend growth rate is approximately 7 percent.

MCC

24. MCC, through the expert witness testimony of Dr. Caroline M. Smith has recommended a rate of return on common equity of 14.5 percent.
25. Dr. Caroline M. Smith attempted to derive a cost of common equity for Great Falls Gas by performing a DCF study where the total return expected by investors equals the current dividend yield plus the expected dividend growth rate
26. Or. Caroline Smith included 14 companies in her DCF analysis. These companies were selected on the basis of two criteria:
 1. That ninety percent or more of net plant, property and investment was devoted to gas distribution utility operations as of year-end 1980.
 2. Inclusion in the Value Line Survey.

27. The average dividend yield for the 14 companies is 9.8 percent.

28. Exhibit (CMS-4) shows most growth rates are in the 3.75 to 4.75 percent range. Roughly one-third are in excess of 5.75 percent. It is Dr. Caroline Smith's judgment that investor expectations for average growth are in the 3.75 to 4.75 percent range.

29. By adding the 9.8 percent dividend yield to a growth rate in the range of 4.3 to 4.7 percent Dr. Caroline Smith concludes that the cost of common equity to the Applicant is 14.5 percent.

Commission Analysis

30. Both witnesses in this case relied at least in part on a DCI analysis. In the selection of companies to include in the studies, both witnesses choose companies whose main business is selling natural gas. This introduces little evidence about what types of decisions an average investor makes. Circularity is a serious concern in the determination of cost of capital, a sample of other types of companies tends to give a better approximation of the market. Dr. Richard Smith indicates that unusual factors should be part of the determination of the cost of capital if they make up part of a sample. Unusual market factors are not useful in setting the cost of capital as rates are usually in effect for sometime.

31. MCC points out a serious deficiency in Dr. Richard Smith's estimates of dividend growth. His estimates are considerably higher than recent actual growth. Some of his estimates extend 18 months beyond the pricing period of some stocks.

32. Dr. Richard Smith attacked the inclusion of Cascade Natural Gas as being very damaging to Dr. C. M. Smith's attempts to show correlation factors.

33. After a careful review of the evidence the Commission finds the approach used by Dr. C. M. Smith to be preferable in determining the cost of equity. In particular her historical growth data is recorded over a long period, which serves as an indication of what growth would be expected by an investor. The computation required in the DCF study performed by Dr. Richard Smith, while certainly possible to duplicate, does not serve as a proxy for investors behavior. The Commission finds a return on equity of 14.5 percent to be the best estimate in this record for the cost of equity to Great Falls Gas.

34. The Great Falls Gas Company has a cost of capital equal to 11.43 percent determined as follows:

<u>TYPE</u>	<u>PERCENTAGE OF CAPITALIZATION</u>	<u>COST</u>	<u>WEIGHTED COST</u>
Long-Term Debt	54.8%	8.90%	4.88%
Common Stock	45.3	14.50	6.55
	100.0%		11.43%

PART C

Rate Base

35. The Applicant offered a test year rate base in the amount of \$5,967,406. MCC proposed an adjustment to remove the amount of \$42,162 from rate base for prepayment of property tax accruals by the ratepayers. The Company points out that Mr. Buckley did not perform any sort of lead-lag study in arriving at his adjustment. During cross-examination Mr. Buckley noted that indeed there might be items which would increase the working capital portion or rate base. It is however, the Applicant's burden to identify any such items. Consistent with this Commission's findings in Docket No. 80.6.33 a reduction to rate base for prepaid property tax accruals is appropriate. The rate base accepted by the Commission is \$5,925,244.

PART D

Cost of Service

36. Mr. Warren Robinson sponsored testimony and exhibits which related to cost of service and rate base amounts for the Applicant.

37. Mr. Frank Buckley presented testimony and exhibits which concerned cost of service and rate base amounts for MCC.

Interest Earned on Industrial Revenue Bonds

38. MCC has proposed an adjustment which would flow back to ratepayers interest which has been earned on the undisbursed proceeds of an industrial revenue bond issue. Since the ratepayers have been paying the interest expense on these bonds since their issuance, MCC feels that the interest which has been earned should reduce that expense. Mr. Buckley has proposed flowing the money back over a two-year period. The proposed adjustment would increase revenues in the test year by \$55,706.

The Applicant resists the proposal of MCC as the adjustment is not in accordance with the provisions of the bond issue, the Company did not cover its actual interest costs, and the adjustment is illegal.

Issuance of bonds by a utility is a normal exercise of business financing. The proceeds of the issue are normally used to retire short-term borrowings or to finance plant expansion. Bonds are not issued to invest the proceeds to earn income. When such an event occurs, any income from undisbursed bond proceeds should offset the bond interest expense for ratemaking purposes. To argue as the Applicant has that all of the income should be retained by the Company is totally unfair to the ratepayers. The arguments concerning the bond requirements have nothing of substance to do with the issue of how to treat this interest income. It is also incorrect to refer to the adjustment as a rebate or a refund. The proposal by MCC does nothing more than match the income and expense associated with the 1979 issue of industrial revenue bonds. The Commission accepts the adjustment proposed by MCC and finds the two-year amortization period to be proper.

Interest Expense for Tax Calculation

39. Mr. Buckley proposed that a pro-forma interest calculation be used in the calculation of income taxes. The calculation involves the multiplication of the proposed rate base by the weighted debt cost. This is an adjustment which has been accepted in some dockets before this Commission.

The Applicant argues that the interest which is actually going to be paid is the relevant consideration in this proceeding. For the purposes of this Docket the Commission finds that the interest expense proposed by the Applicant in the amount of \$297,700 is accepted as being the most accurate estimation of actual interest expense.

Sales Volumes

40. Sales volumes were not a contested issue in this Docket. Both parties agreed to use normalized volumes at May 31, 1981. The Phillips load is included at 289,150 MCFs.

41. The Commission finds that Great Falls Gas is entitled to \$287,263 of additional annual gross operating revenue as follows:

SCHEDULE I

GREAT FALLS GAS COMPANY – Overall Cost of Service

Based on Normalized Sales Volumes – 12 Months Ending 5/31/81

	(A)	(B)	(C)	(D) Test Period	(E)
	12 Mos. Ended 5/31/81	Adjustment	Present Interim Rates	Adjustment	Accepted By The Commission
Operating Revenues	19,022,194	4,364,967	23,387,161	287,263	23,675,424
Cost of Service:					
Gas Purchased	16,215,391	3,947,342	20,162,733		20,162,733
Other Operation:					
Distribution	399,730	36,006	435,736		435,736
Customer Accounts	504,479	162,228	666,707		666,707
Customer Services	62,659	161,278	223,937		223,937
Administrative & General	605,280	42,538	647,818		647,818
Maintenance	175,706	11,518	187,224		187,224
Depreciation	268,556	10,144	278,700		278,700
Taxes:					
Other than Income	166,019	16,260	182,279		182,279
Federal Income-Current (Net Investment Credit)	(141,227)	143,184	1,957	119,279	121,236
Federal Income-Deferred	259,105	(192,019)	67,086		67,086
State Income	(26,986)	31,309	4,323	19,390	23,713
Total	18,488,712	4,369,788	22,858,500	138,669	22,997,169
Utility Operating Income	533,482	(4,821)	528,661	148,594	677,255
Rate Base (OC-D)	5,799,240	126,004	5,925,244		5,925,244
Rate of Return (OC-D)	9.20%		8.92%		11.43%

- 1) Includes interest income of \$55,706.
- 2) Uses company use and loss ratio of 2.98% for computation of purchased gas costs.
- 3) Uses Federal tax rates for 1st 4 - \$25,000 increments of 17%, 20%, 30% and 40% rather than straight 46% rate.

SCHEDULE 2
Great Falls Gas Company
REVENUE DEFICIENCY AT PRESENT RATES
Twelve Months Ending May 31, 1981

1.	Rate Base	\$5,925,244	
2.	Recommended Rate of Return	11.43%	
3.	Recommended Return		\$677,255
4.	Adjusted Net Operating Income		<u>528,661</u>
5.	Income Deficiency		\$148,594
6.	Tax Multiplier		
			A
7.	Revenue Deficiency		\$287,263

A

Taxes were calculated on an incremental basis for the first \$100,000 of income.

PART E
Other Issues

42. Energy Audits. During the hearing cross-examination revealed that with current personnel, it will take a long time to perform energy audits for the City of Great Falls. In order to speed the rate of energy audits the Commission hereby directs that if a customer receives an audit from any person or group meeting the Montana RCS standards, that audit can be utilized to obtain a zero interest loan.

43. Solar Equipment. At the present time there is no provision for solar energy equipment in the zero interest loan program. While mindful that this is an area of new technology, the Commission feels that energy development is a vital element in the attempt to develop renewable resources. Solar equipment should qualify for the zero interest loan program for homes which; have already been fully insulated and weatherized which have proper exposure, and where the equipment has a realistic pay back period. Great Falls Gas is not liable for any defects in solar equipment selected by a customer. The loan ceiling is not changed by this modification.

44. Zero Interest Loan Program. The Applicant has renewed its request for an interest charge for the zero interest program. As was noted in Order No. 4804a the use of estimates is found to be unacceptable. Finding of Fact No. 6 in Order No. 4804a is affirmed.

CONCLUSIONS OF LAW

1. The Applicant, Great Falls Gas Company, is a "public utility" within the meaning of Montana law, Section 69-3-100, MCA.
2. The Commission properly exercises jurisdiction over the Applicant's rates and operations pursuant to Sections 69-3-102 and 69-3-302, MCA.
3. The rate structures authorized by the Commission, based upon Order No. 4602a, are just, reasonable and not unjustly discriminatory.

ORDER

THE MONTANA PUBLIC SERVICE COMMISSION ORDERS THAT:

1. Great Falls Gas Company shall file rate schedules which reflect an annual revenue increase of \$287,263 for gas service, based on the test period ending May 31, 1981.
2. The increased gas revenues authorized herein shall be distributed to Applicant's classes of service using the rate design in Order No. 4502a.
3. Applicant shall file revised schedules incorporating the changes in its rate schedules approved herein. The schedules shall become effective for service rendered on and after November 30, 1981.
4. All motions and objections not ruled upon at the hearing are denied.

DONE IN OPEN SESSION at a meeting of the Montana Public Service Commission held the 30th day of November, 1981, by a vote of 5-0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION.

GORDON E. BOLLINGER, Chairman

JOHN B. DRISCOLL, Commissioner

HOWARD L. ELLIS, Commissioner

CLYDE JARVIS, Commissioner

THOMAS J. SCHNEIDER, Commissioner

ATTEST:

Madeline L. Cottrill
Secretary

(SEAL)

NOTE: You may be entitled to judicial review of the final decision in this matter. If no Motion for Reconsideration is filed, judicial review may be obtained by filing a petition for review within thirty (30) days from the service of this order. If a Motion for Reconsideration is filed, a Commission order is final for purpose of appeal upon the entry of a ruling on that motion, or upon the passage of ten (10) days following the filing of that motion. cf. the Montana Administrative Procedure Act, esp. Sec. 2-4-702, MCA; and Commission Rules of Practice and Procedure, esp. 38.2.4806. ARM.